July 14, 2006

MEMORANDUM TO: State Investment Council

FROM: O. Ike Michaels, Jr. s/O. Ike Michaels, Jr.(crb)
Associate Director

SUBJECT: **Proposed Real Estate Investment in Funds to be Managed by TA Associates, Warburg Pincus, RLJ Capital Partners, and MacFarlane Urban Realty Company**

This due diligence memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.12 to report on proposed real estate investments of (a) $100 million in the TA Associates Realty Fund VIII ("Fund VIII") managed by TA Associates Realty ("TA"); (b) $100 million in the Warburg Pincus Real Estate Fund I ("WPRE-I") managed by Warburg Pincus, LLC ("Warburg"); (c) $75 million in the RLJ Lodging Fund II ("RLJ Fund II") managed by RLJ Capital Partners II, LLC ("RLJ Capital"); and (d) $75 million in the MacFarlane Urban Real Estate Fund II, LP ("Fund II") managed by MacFarlane Urban Realty Company, LLC ("MURC"), a subsidiary of MacFarlane Partners, LLC ("MacFarlane").

Please note that these investments will be authorized pursuant to Articles 69 and 71 of the Council's regulations, which became effective on June 20, 2005. These investments will be considered real estate investments as defined under N.J.A.C. 17:16-71.2 (a).

The Alternative Investments Procedures adopted by the Council on January 20, 2005 require any potential alternative investment opportunities to be identified and initially evaluated by the Head of Alternative Investments of the Division (Bill Clark in an acting capacity) and the applicable Asset Class Consultant (The Townsend Group for Real Estate, or "Townsend") in coordination with the DOI Investment Committee (Bill Clark and myself).

As a result of internal and external sourcing, the DOI Investment Committee identified the proposed investments, and Townsend and Division staff proceeded to undertake extensive due diligence on the proposed investments. We completed the same due diligence process as with all the other alternative investment opportunities presented to the Council.

Based on this due diligence, the Division has determined that the proposed investments meet the criteria for investments set forth in the Alternate Investment Procedures.

TA Associates Realty Fund VIII ("Fund VIII") is a continuation of the strategy that TA has employed in its previous six funds (TA's first fund invested in core assets). Fund VIII plans to invest in the four major property types throughout the United States, with a strong emphasis on finding properties in major markets, particularly along the coastal regions. Historically, most of TA's investments have been in the industrial and office sectors (typically 35% to 50% in each property type in the prior funds), with the balance in multifamily and retail properties. TA's value creation approach is to buy at a discount to replacement cost, acquire assets that can generate strong current income, and actively manage the leasing to create value. TA is targeting a fund size of $900 million to $1 billion with a targeted total gross return for Fund VIII of approximately 15%-16% before fees (approximately 13%-14% net of fees); with an emphasis on current income (typically 9% to 11% leveraged income returns during the holding period). This strategy has limited development (typically less than 10%) and a relatively moderate level of leverage of approximately 50%. In the past, TA has been able to maintain targeted returns in lower return environments not by taking on significant leasing risk or life cycle risk but by employing more leverage (it will likely have a floor of 50% loan to value over the life of the Fund, but initially will be 100% leveraged as they finance the first half of the portfolio before calling equity) and using shorter holder periods for underlying investments. Together, these two elements have allowed TA to maintain a mid-teen return target in environments of lower expected returns. Since inception, TA's funds have generally exceeded the NPI over most time periods.

The investment manager - TA Associates Realty - which currently manages $8.6 billion in real estate assets, including $4.9 billion in value added funds, has extensive experience with similar types of investments and strategies, and their track record is very strong. All the legal and economic terms associated with this Fund are fair and consistent with market standards.

The **Warburg Pincus Real Estate Fund I** ("WPRE-I") is the first dedicated real estate fund by Warburg Pincus, LLC and will focus on growth and value creation opportunities globally with a primary focus on Asia (China and India – 50%) and North America and Europe (50%). Although commingled with $22 billion previously invested in 525 companies in over 30 countries, <u>Warburg Pincus has invested $1 billion in a variety of real estate investments and generated a realized 30% IRR and 2.1x multiple</u>. The Fund's target return is 25% and $350 million has already been committed to seven investments in four countries since December 31, 2005.

We consider Warburg Pincus to be an experienced alternative investment manager with a global expertise and network that will benefit the Fund. As with our previous investment with the Blackstone Real Estate Fund, we believe Warburg Pincus' global private equity platform has and will assist the Fund in sourcing and evaluating attractive global real estate opportunities. Moreover, Warburg Pincus, LLC and its employees are committing $40-$50 million of the Fund which has a 1% management fee, a 9% preferred return, and no transaction or acquisition fees. Accordingly, all the legal and economic terms associated with this Fund are fair and consistent with market standards.

The RLJ Lodging Fund II ("RLJ Fund II") sponsored by RLJ Development, LLC ("RLJ") is expected to continue and broaden the investment strategy implemented in the first fund ("RLJ Fund I") which closed in April 2005 with $315.5 million of commitments and is fully invested with a 21.4% gross IRR and 2.1x multiple as of December 31, 2005. Most investors in RLJ Fund I (including CalPERS, CalSTRS, GE, Allstate Insurance, States of North Carolina, Georgia and Connecticut, and Hilton) have re-upped in RLJ Fund II with larger amounts. RLJ Fund II will target a 17% gross levered annual IRR and approximately 91% of RLJ Fund II is pre-specified as the investment manager successfully completed an off-market purchase of an 100-hotel portfolio comprised primarily of focused-service assets. This portfolio was previously managed by White Lodging, one of the industry's preeminent hotel management companies and developers, under a long-term (40-year) management agreement. The 100-hotel portfolio is geographically diversified with 90% of properties affiliated with the Marriott family of brands and 5% Hilton-affiliated.

The RLJ Lodging Fund II ("RLJ Fund II") is our first dedicated lodging investment which seeks to invest in focused-service hotels in major metropolitan areas which present significant opportunities for value-enhancement. Senior management led by Robert L. Johnson (previously of BET) and Thomas J. Baltimore have more than 20 years of hospitality industry experience, and the General Partner and its affiliates will invest $22.5 million in RLJ Fund II (or 3% of the fund). A favorable sliding scale investment management fee is based on total amount of commitments, and all the legal and economic terms associated with this Fund are fair and consistent with market standards.

The **MacFarlane Urban Real Estate Fund II, LP** ("Fund II") is a continuation of a successful strategy initiated on behalf of the California Public Employees Retirement System ("CalPERS") in 1995. Since that time, the fund manager MacFarlane Urban Realty Company, LLC ("MURC"), a subsidiary of MacFarlane Partners, LLC ("MacFarlane"), has invested approximately $1.1 billion ("Fund I") in equity and equity equivalents in 25 "qualified" individual urban assets valued at over $5.7 billion. These investments have generated a 36% IRR (leveraged, net of all fees) from inception through December 31, 2005. Fund II has a target return of 16-18% IRR (leveraged, net of all fees) and to date, MURC has qualified 50 urban communities (including the New Jersey cities of Newark, Harrison, and Jersey City) for opportunistic investments using a stringent proven qualification methodology that takes about three years and is focused on population density, improving demographics, barriers to entry, complex land-use regulations and entitlement processes, underserved niches, and strong public and private commitment.

The investment manager, MacFarlane Urban Realty Company, LLC ("MURC"), a subsidiary of MacFarlane Partners, LLC ("MacFarlane") with 61 employees, has extensive experience with similar types of investments and strategies, and their track record is strong dating back to 1995. As of December 31, 2005, MURC had $2.2 billion in investor equity under management and $8 billion in properties completed or under construction. The General Partner, together with their affiliates, will commit $20 million (or 2% of the fund). The management fees are reasonable (1.5% on committed capital), and all the legal and economic terms associated with this Fund are fair and consistent with market standards.

Formal written due diligence reports for these proposed investments were sent to each member of the Investment Policy Committee of the Council on Thursday, July 6, 2006. In addition to the formal written due diligence reports, all other information obtained by the Division on these investments was made available to the Investment Policy Committee.

The Investment Policy Committee held a meeting on July 10, 2006 to review the due diligence reports prepared by Townsend and Division staff and other information for these proposed investments. After reviewing this material, the Investment Policy Committee has decided to report on these proposed investments ($100 million in the TA Associates Realty Fund VIII, $100 million in the Warburg Pincus Real Estate Fund I, $75 million in the RLJ Lodging Fund II, and $75 million in the MacFarlane Urban Real Estate Fund II, LP ("Fund II").)

Pursuant to Step 4 of the Alternative Investments Procedures. Under these procedures, the Council may adopt or otherwise act on this report.

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern these investments. In addition, these proposed investments must comply with the Council's "pay to play" regulation (N.J.A.C. 17:16-4). While we are confident that we will work through these issues, the potential exists that a successful resolution will not be reached with one or more of the general partners.

We look forward to discussing the proposed real estate investments at the Council's July 20, 2006 meeting.

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Attachments